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Nepal and SAFTA: Issue, prospects and challenges

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1. Introduction

The Preamble to the Agreement on South Asian Free Trade Area (SAFTA) expects the it to act "as a stimulus to the strengthening of national and SAARC economic resilience, and the development of the national economies of the Contracting States by expanding investment and production opportunities, trade, and foreign exchange earnings as well as the development of economic and technological cooperation" (SAARC Secretariat 2004). Having juxtaposed the above spirit of SAFTA with the provisions relating to the least-developed countries (LDCs), Nepali policy makers had reasons to believe that joining SAFTA would help Nepal to expand its exports to countries other than India, collectively called "Rest of South Asia" (RSA), and thereby contribute to geographic export diversification. If Nepal's intra-regional trade during the first five years of implementation of SAFTA is any guide, this objective is far from being achieved. However, this is not unique to Nepal; this is the plight of most of the LDCs in the region, which are heavily dependent on the two largest economies of the region for their regional trade (Adhikari, forthcoming).

While the faulty Agreement resulting from the mercantilist mindset of trade negotiators in the region is partly responsible for this predicament, we argue that internal inconsistencies of Nepal's trade policy vis-à-vis SAFTA as well as supply-side constraints are equally responsible for Nepal's inability to fully utilize SAFTA to its advantage.

This paper discusses Nepal's trade (particularly export) prospects with RSA, the barriers and constraints to tapping the trade potential, and how SAFTA can be strengthened to help address them. It must be pointed out at the very outset that the analysis in this paper is predominantly in the context of Nepal's trade relations with India. This is because India accounted for 90 percent of Nepal's exports to South Asia, and 99 percent of Nepal imports from South Asia in 2009. Although we note that that services trade is immensely important[1] and the SAARC Agreement on Trade in Services[2] has been signed, the paper focuses exclusively on merchandise trade.

The rest of the paper is organized as follows. Section 2 provides a brief background on Nepal's trade performance. Section 3 discusses Nepal's trade with India, focusing on the bilateral trade treaty and the barriers faced by Nepali exports. Section 4 highlights the implications of SAFTA membership for trade with India. Section 5 discusses the trend of Nepal's trade with RSA, assesses the export potential, and shed lights on the barriers and constraints to realizing that potential. Section 6 is devoted to Nepal's supply-side constraints. The last section summarizes the discussion and provides some recommendations.

[1] Services exports and imports accounted for, on average, 42.7 percent and 18 percent of total exports and imports of Nepal respectively during 2007/08-2009/10.
[2] At the 16th SAARC Summit held Thimpu in April 2010.

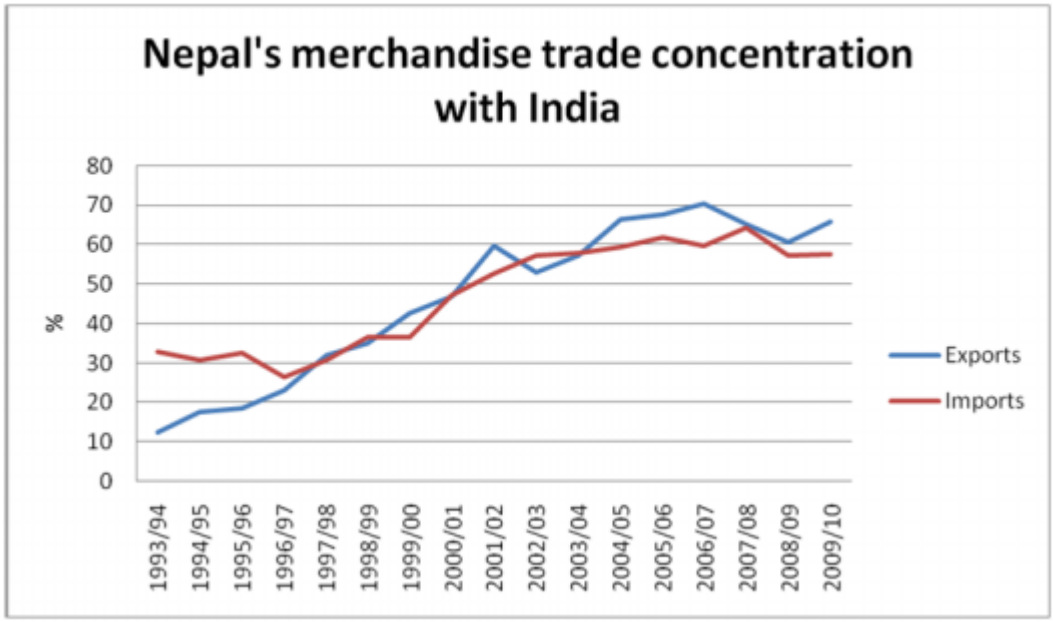
2. Nepal's trade performance

Securing better market access conditions for its exports, achieving product-wise and destination-wise export diversification and reducing trade deficit are key motivations behind Nepal's pursuit of negotiating trade agreements.[3] Having applied for World Trade Organization (WTO) membership in 1995, it obtained the same in 2004. It has been party to regional trade liberalization initiatives in South Asia: it was a member of the positive-list-based SAARC Preferential Trading Arrangement (SAPTA), which was signed in 1993 and came into force in 1995, and is a member of SAFTA, which has replaced SAPTA and is in force since July 2006. At the trans-regional level, it is a member of the Bay of Bengal Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Agreement (FTA), which is yet to come into operation. At the same time, Nepal has applied for the membership of the Asia Pacific Trade Agreement (APTA), also known as the Bangkok Agreement.

However, Nepal's foreign trade continues to be concentrated with India, with which it has had a bilateral preferential trade agreement since 1950. Trade dependence on India has increased over time, and, more alarmingly, so has the merchandise trade deficit, which is being largely financed by remittances. From 24.5 percent in the mid-1990s, the share of merchandise exports to India increased to an average of 64 percent during 2007/08-2009/10. Likewise, the share of merchandise imports from India increased from 30 percent to 59.6 percent during the same period (Figure 1). If informal trade is taken into account, the dependence is even higher, with a study showing informal trade to be 38 percent-103 percent of formal trade in 2000-2001 (Karmacharya et al. 2004).

Figure 1

[3] See Nepal's Trade Policy, 1992 and Trade Policy, 2009, which has replaced the former. They are available, respectively, at www.nepalchamber.org (accessed 3 May 2011) and www.mocs.gov.np (accessed 3 May 2011).

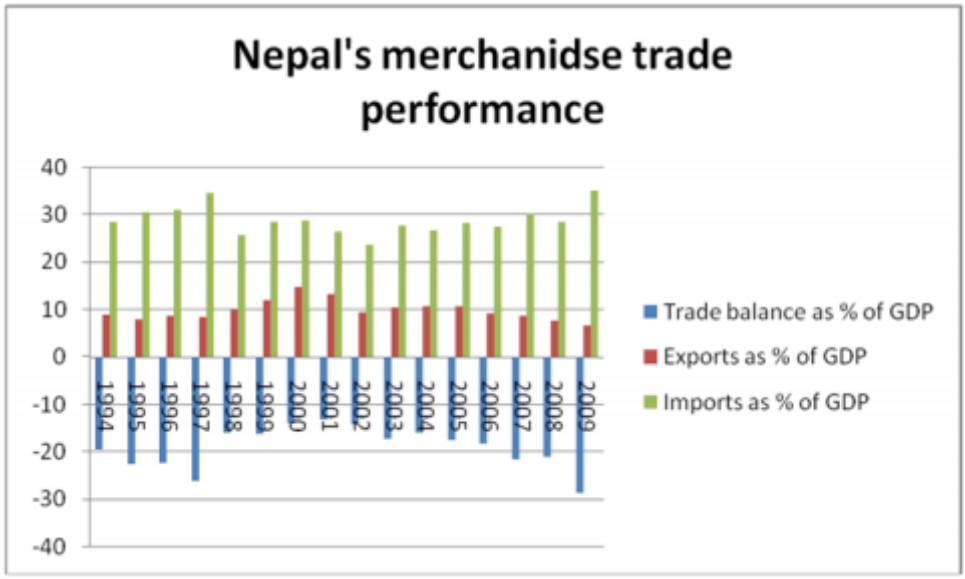


Source: Nepal Rastra Bank, "Recent Macroeconomic Situation", various issues.

In the decade 2000-2009, the merchandise trade deficit as a percentage of GDP more than doubled to 28.6 percent (Figure 2). The overall merchandise export-import ratio has more or less continuously fallen since 2004/05, reaching 16 percent in 2009/10 (a slightly better 18.4 percent with India). The trade deficit with India accounted for on average 58.6 percent of Nepal's total trade deficit during 2007/08-2009/10.

After India, Nepal's major export destinations are the European Union (EU), the United States (US), Bangladesh and China (in 2009). Nepal's major sources of imports after India are China, the EU, Saudi Arabia and East Asian countries (in 2009)

Figure 2



Source: World Bank's World Development Indicators

3. Trade with India

Nepal and India have had a bilateral trade agreement for the last six decades. From Nepal's market access perspective, the Nepal-India Trade Treaty, last renewed in October 2009 for seven years, has been particularly restrictive since 2002, when a much liberal Treaty signed in 1996 was replaced. The Treaty, which covers only goods trade, provides for, *inter alia*, exemption from basic customs duty and quantitative restrictions imports of listed primary (including agricultural) goods on a reciprocal basis; access for Nepali manufacturing products, except for three items on the negative list,[4] to the Indian market free of customs duties; and preferential entry of goods from India to the Nepali market.[5] However, a number of restrictive provisions, which were introduced in the renewal of the Treaty in 2002, have diluted the duty-free provision for Nepali products:

- Stringent rules of origin (ROO) requiring Nepali exporters to fulfil the twin criteria of 30 percent value addition and change in tariff heading at the four-digit level of the Harmonized Commodities Description and Coding System (HS)[6] for the products to be eligible for preferential market access.
- Tariff-rate-quota for four major products of export interest to Nepal with zero-duty treatment provided for in-quota items, namely vegetable ghee (100,000 tons), acrylic yarn (10,000 tons), copper products under HS Chapters 74.00

[4] The items on the negative list are: alcoholic liquors/beverages and their concentrates except industrial spirits; perfumes and cosmetics with non-Nepali/non-Indian brand names; and cigarettes and tobacco.
[5] Protocol to Article VI states that Nepal, "with a view to continuing preferences given to Indian exports, will waive additional customs duty on all Indian exports during the validity of the Treaty". The concession rate has varied over the years.
[6] Change in tariff heading at the four-digit level entails substantial processing, indicating that goods have undergone transformation from one tariff heading into another. An example relating to the iron and steel sector would be that goods get transformed from stainless steel ingots (HS heading 72.18) to flat-rolled products of stainless steel (HS heading 72.19).

and Heading 85.44 (10,000 tons) and zinc oxide (2,500 tons); and most-favoured-nation (MFN) duty for any exports above these thresholds.

- Requirement for Nepal to submit the criteria applied for ROO on an annual basis.
- Clear specification of safeguard clauses, which define "injury" with a much more convenient trigger mechanism for the imposition of safeguard duty over and above normal tariff.[7]

That a liberal trade treaty, taking into account Nepal's supply-side constraints, can help work wonders for the country's export performance with its largest trading partner was demonstrated by the 1996 version of the trade treaty. The most significant provision of the treaty was duty- and quota-free access for Nepali manufactures, without respect to the origin of raw material inputs in the production process, as long as there is some local value added in manufacturing. Exports increased by 7.6 times between 1995/96 and 2001/02 while imports grew, at a much slower rate, by 2.3 times during the same period. There was a marked shift in the composition of exports, away from primary goods to manufactured goods. [8]

With the revision of 2002, on the one hand, manufacture items exhibiting promising export growth were targeted with quantitative restrictions, and on the other, the onerous ROO, besides hurting existing exports, erected a barrier to emergent and potential exportable goods.[9] The ostensible grounds for introducing ROO way beyond the capacity of an LDC with a weak industrial base and serious supply constraints[10]—were to "promote genuine industrialization" in Nepal and "provide clarity and transparency" to the preferential scheme (Shrestha 2003). In practice, however, ROO has been used as a means of disguised protection. Global experience shows that there is no evidence that strict ROO has helped beneficiary countries create a viable industrial base.[11] Indian goods, however, do not have to fulfil any ROO to gain preferential access to the Nepali market.

Quantitative restrictions are not confined to those stipulated in the Treaty. There are cases of imports of certain products from Nepal being banned unilaterally on and off. Garlic exports are a case in point: imports of garlic from Nepal are banned from time to time with the allegation that Chinese garlic is finding its way into India although the local certificate of origin attests to their Nepali origin.[12]

Application of sanitary and phytosanitary (SPS) measures and technical standards constitutes another critical impediment to Nepali exports to India. Agricultural and forest products—goods identified by the government for export promotion[13]—as well as manufactured goods like readymade garments (RMG) and pharmaceuticals face

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[7] See Adhikari (2010a) for further details.
[8] See Kharel (2008 and 2010a) for details of the impact of the liberal provision.
[9] See Adhikari (2010a) and Kharel (2008 and 2010a) for analysis of the impact of the restrictive provisions.
[10] Agrawal (2008), for example, suggests that the steep value addition requirement is not achievable even for Indian industries.
[11] See WTO (2005).
[12] "India bans Nepal's garlic export", *Republica*, 29 December 2010, http://www.myrepublica.com/portal/index.php?action=news_details&news_id=26583
[13] See GoN (2010).

these non-tariff barriers (NTBs).[14] There is no predictability in the way quarantine-related rules are applied (Adhikari 2008). The requirement to subject export samples to testing in India—in some cases, in New Delhi—discourages exports. India does not recognize Nepali pharmaceuticals approved by Nepal government's Department of Drug Administration. A sample from the export consignment has to be taken to the central authority in New Delhi for testing and it takes anywhere between 6 and 12 months for the results to be out, by which time the medicines in the consignment waiting at the border may well have crossed the date of expiry.[15] This is a major reason why Nepali pharmaceuticals, despite possessing export potential, [16] have not made inroads in the Indian market.[17]

Para-tariff barriers are another concern. A case in point is the imposition in 2009 of Special Additional Duty (SAD) on Nepali RMG, for which India has emerged as a major market after the expiry of the Agreement on Textiles and Clothing (ATC) of the WTO that saw Nepal lose a substantial market share in the United States (US), traditionally the largest market for its RMG exports. Furthermore, countervailing duty (CVD), levied on imports to balance the excise duty imposed on like domestic products, was imposed on the maximum retail price of RMG instead of the border price as is the standard international practice.[18] Besides directly hurting exports, the unpredictability associated with the imposition of such extra duties and charges, even if they are withdrawn later, has undermined investors' confidence in Nepal.

An attempt has been made in the 2009 revision to the Treaty to address the problem of lack of mutual recognition of standards and testing. Much will hinge on the implementation of India's "best endeavours" pledge made in the Treaty to assist Nepal to increase its capacity to trade through improvements in technical standards, quarantine and testing facilities and related human resource capacities (Kharel 2010a). While the old Treaty was silent on para-tariff and non-tariff barriers—which played havoc with Nepali exports—the revised Treaty of 2009, in its Protocol to Article I, says that the two sides *shall undertake measures* to *reduce or eliminate* non-tariff, para-tariff and other barriers that impede promotion of bilateral trade. But this is a weak formulation and does not entail a binding commitment to categorically eliminate such barriers.[19]

While these market access barriers hurt Nepal's export performance, it must be noted that supply-side constraints within Nepal (to be discussed in section 6) also crucially affect its export performance.

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[14] For example, based on our discussion with Mr. Uday Raj Pandey, President, Garment Association of Nepal, we found that India imposes NTBs such as the requirement to certify that RMGs being exported to India are free of certain chemical substances (such as azo) and the requirement to obtain a certificate from laboratory in New Delhi to certify that certain products contain less than 51 percent nylon in order to qualify for lower level of Countervailing Duty (CVD).

[15] Umesh Lal Shrestha, President, Nepal Association of Pharmaceutical Producers and Managing Director, Quest Pharmaceuticals Pvt Ltd, in an interview to *Karobar* national business daily ("Nepali pharmaceuticals are of good quality yet low-priced", 8 February 2011, p 12)

[16] Ibid.

[17] In 2009, Nepal exported pharmaceutical products (Chapter 30) worth US$1.6 million to India. This was 85 percent of Nepal's total pharmaceutical product exports for the year.

[18] Sharma, Milan Mani. 2009. "India imposes 4pc CVD; Garment exports come to a grinding halt", *Republica*, 7 October.

[19] See Kharel (2010a) for further details.

4. SAFTA membership and trade with India

SAFTA does not offer additional market access for Nepal in the Indian market. As noted above, Nepal already enjoys basic customs duty-free market access to the Indian market in almost all products, subject to ROO. The ROO under SAFTA is exactly the same as in the Nepal-India Trade Treaty, which as alluded to earlier is extremely onerous for Nepali enterprises to fulfil. The ROO needs to be made simple, transparent and, for LDCs, less stringent (see, for example, Adhikari 2010a).

Preference erosion in the Indian market as India grants more and more concessions to LDCs is a challenge for Nepal. India's sensitive list for LDCs has been reduced to 480 items from the original 763 (Rahman and Rahman 2010). Moreover, the effectively applicable sensitive list for Bangladesh has 323 items (Rahman 2010a). While 157 apparel items still remain in India's sensitive list for LDCs, Bangladesh has been given duty-free access for 8 million pieces, though it has not been able to fully utilize this tariff-rate-quota (only 2.3 million and 3 million pieces were exported to India in 2008 (April–December) and 2009 respectively) (Rahman 2010a). Likewise, under a Free Trade Agreement, Bhutan enjoys better market access conditions in the Indian market than does Nepal: duty-free access without quantitative restrictions and ROO. Similarly, under the India-Afghanistan Preferential Trade Agreement, in force since 2003, Afghanistan gets preferential market access (with the margin of preference ranging from 50 percent to 100 percent) to the Indian market for 38 listed items, albeit with ROO more stringent than for Nepal. Limited supply-side capacity and competitiveness means that preference erosion could adversely impact Nepali exports.

Although there are no extra benefits in terms of tariff preferences, there could be potential benefits in other areas from SAFTA for Nepal's trade with India. Compared to a bilateral agreement, a regional agreement, though the negotiation process may be slower, can provide a more predictable trading environment for the smaller party. An effective dispute settlement mechanism under SAFTA which can be moved to also resolve disputes under bilateral trade treaties can help ensure better implementation of treaty provisions. At present, the dispute settlement body (DSB) under SAFTA is not independent, with the Committee of Experts, comprising government officials, acting as the DSB. There is no special treatment for LDCs with respect to dispute settlement.

In the previous section, we discussed that a host of para-tariff and non-tariff barriers/measures are critical barriers to Nepal's exports to India. Removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive under SAFTA may help address Nepal's concerns regarding the same in India.

On the import front, Nepal has placed on its SAFTA sensitive list 140 of 273[20] agricultural tariff sub-headings (covering Chapters 1, 3, 4, 6-12, 14, 15, 17 and 23 at HS 2007 six-digit level) in which it provides basic customs duty-free access to

[20] There are 274 such tariff lines as per Customs Tariff Schedule published by Department of Customs, Government of Nepal for 2009/10. But one tariff line is at the eight-digit level (HS 17011190), which is ignored for this analysis based on six-digit tariff lines. A few more products were added to the list in the October 2009 revision to the trade treaty with India, which are not considered here.

products from India and Tibet, the autonomous region of PRC. Out of the 273 items, 173 were actually imported in 2009. These products, when imported from India and Tibet, China, are subject to a 5 percent agricultural development fee (ADF), which has been falling since Nepal's accession to the WTO, while the MFN tariff is 10 percent, implying that India and Tibet, China enjoy a 5 percent duty advantage. India is a major supplier of these products accounting for 83.4 percent of such imports in 2009, with an import share of 66 percent or more in 136 of the 173 tariff sub-headings. China accounted for 6.4 percent. Together with China, India accounted for 66 percent or more of the value of imports in 143 of the 173 tariff sub-headings. RSA, which faces MFN tariff, accounted for a paltry 0.2 percent of the total imports of these products.

As per Nepal's commitment under the WTO, ADF (which falls under "other duties and charges" within the meaning of the Article II:1(b) of the GATT 1994) will have to be removed by 2013. Moreover, during a joint secretary-level bilateral trade talks in early March 2011, Nepal agreed to scrap the ADF levied on Indian products, suggesting that the removal may happen well before 2013.[21]

It appears logical to extend complete duty-free treatment to the same agricultural products from other South Asian countries (and also China). Consumers' choice may increase, import sources may diversify and the cost of trade diversion may reduce, while domestic competitiveness concerns are unlikely to be aggravated by the extension. It may also strengthen Nepal's negotiating position under SAFTA and enable it to secure the removal of some, if not all, products of its export interest from other South Asian partners' sensitive lists.

However, there are concerns about duty-free entry of Indian agricultural products, including subsidized ones, adversely affecting the Nepali agricultural sector, which contributes 32 percent of GDP and employs 74 percent of the economically active labour force as the major occupation. It was to secure the policy space to increase tariffs if needed to protect the agricultural sector that Nepal, when acceding to the WTO, set its bound tariffs on agricultural goods generally at a much higher level than the applied rates—for example, bound rates for cereals are 50-60 percent.[22] Keeping these items on the SAFTA sensitive list while affording zero-duty treatment to the same products from India suggests a lack of clarity on the part of the government of Nepal as to the protection of the agricultural sector.

In general, Nepal should strive to accord the same treatment on trade matters to all SAARC members. This is important to reduce, if not eliminate, the cost of trade diversion and alleviate the stress on scarce capital for negotiating and implementing multiple trade agreements.

5. SAFTA: Trade with other South Asian countries

[21] Revenue from ADF in 2009/10 amounted to NRs. 497.34 million, or 1.4 percent of the country's total trade tax revenue.
[22] See Nepal's schedule of concession available at WTO website.

5.1 Exports

In 2009, Nepal's exports to RSA amounted to US$66 million, or 7.5 percent of its total exports, compared to 1.5 percent in 2003 (Table 1). This represents an annual average growth rate of 38 percent during 2003-2009, significantly higher than the growth rate of exports to the world (5.2 percent) and to India (8.7 percent) during the same period. However, exports to RSA are highly concentrated with Bangladesh. The US$60.8 million of exports to Bangladesh in 2009 represented 91 percent of exports to RSA. Accounting for about 7 percent of Nepal's total exports, Bangladesh was Nepal's third largest export partner after India and the US in 2009. No other South Asian country was among Nepal's top 20 export partners (out of 144), though Nepal exported to all of them in 2009. Barring Bangladesh, individual shares of RSA countries were less than 0.3 percent.

Table 1: Nepal's exports (US$ million)

	1994	**1999**	**2003**	**2009**	**% annual average growth (2003-09)**
World	384.84	524.29	652.69	886.00	5.23
India	44.17	186.60	341.80	562.81	8.67
Bangladesh	0.44	18.19	6.11	60.84	46.69
Bhutan	-	0.36	1.37	2.52	10.71
Sri Lanka	2.44	0.04	1.19	2.09	9.82
Pakistan	0.01	0.42	0.99	1.11	1.87
Maldives	-	-	-	0.05	-
Afghanistan	-	-	-	0.03	-
SA	47.06	205.61	351.46	629.45	10.20
RSA	2.88	19.01	9.66	66.64	37.98
Share of SA (%)	12.23	39.22	53.85	71.04	
Share of India (%)	11.48	35.59	52.37	63.52	
Share of RSA (%)	0.75	3.63	1.48	7.52	

SA=South Asia, RSA=Rest of South Asia
Source: COMTRADE accessed through World Integrated Trade Solution (WITS), and authors' calculations

Exports of lentils to Bangladesh explain the dramatic increase in Nepal's exports to RSA: lentils accounted for 72 percent of Nepal's exports to Bangladesh in 2009. Nepal exported lentils—its second largest export product—to 27 countries in 2009, with Bangladesh being the top importer, accounting for 60 percent of the export value. It must be noted, however, that the ban introduced in 2006 on lentils exports by India, then the leading source of lentils imports for Bangladesh[23], largely explains the surge in lentils exports from Nepal to Bangladesh, which, on its part, saw domestic lentils production fall from 2004 onwards and plunge by 40 percent between 2007-2008.[24] Nepal's total exports to Bangladesh increased by 122 percent and 800 percent in the two years following 2005/06.[25]

[23] In 2006, India accounted for 35 percent of Bangladesh's imports of lentils in value terms and 29 percent in quantity terms (authors' calculation based on COMTRADE data).
[24] FAOSTAT, http://faostat.fao.org, accessed 10 March 2011.
[25] This is based on data of Trade and Export Promotion Centre, Government of Nepal.

The sustainability of lentils exports is questionable because growth in domestic production has not matched growth in exports. For example, while exports increased by 12,308 tonnes in 2008 over 2007, domestic production decreased by 3,547 tonnes in the same period even as imports increased by just 31 tonnes. Likewise, in 2009, while domestic production decreased by 13,422 tonnes, exports increased by 40,350 tonnes and imports increased by 31,996 tonnes, with India supplying over 99 percent of imports in quantity terms as well as value terms. After accounting for exports to India (1,129 tonnes), the net imports from India in quantity terms amounted to about 56 percent of exports of lentils to the rest of the world (including Bangladesh). This points to the possibility of re-export trade being behind the boom in lentil exports. The terms of trade in lentils, however, is heavily in Nepal's favour, with the export unit value more than thrice the import unit value in 2009.

5.2 Imports

Relative to exports, Nepal's imports from RSA are low, amounting to US$14 million in 2009, implying a trade surplus of US$42 million with RSA (Table 2). Imports from RSA grew at a slower rate than imports from the world (13 percent) and India (14.3 percent) during 2003-2009. The share of RSA in Nepal's total imports thus fell from 0.6 percent in 2003 to 0.4 percent in 2009. In contrast to exports, imports from RSA are relatively diversified across countries. Bangladesh, Bhutan and Pakistan accounted for 38.4 percent, 32.5 percent and 23 percent of imports from RSA respectively. None of the countries in RSA, however, were among the top 20 import partners (out of 141) of Nepal in 2009.

Table 2: Nepal's imports (US$ million)

	1994	**1999**	**2003**	**2009**	**% annual average growth (2003-09)**
World	1,111.04	1,347.48	1,801.62	3,754.39	13.02
India	429.84	619.86	954.91	2,131.93	14.32
Bangladesh	14.67	8.97	4.85	5.40	1.78
Bhutan	2.30	0.79	0.57	4.55	41.43
Sri Lanka	0.55	1.42	1.99	0.75	-14.98
Pakistan	4.49	13.21	3.30	3.21	-0.45
Maldives	-	-	-	0.00	-
Afghanistan	0.00	-	0.03	0.08	18.90
SA	451.85	644.25	965.65	2,145.93	14.23
RSA	22.01	24.39	10.74	14.00	4.50
Share of SA (%)	40.67	47.81	53.60	57.16	
Share of India (%)	38.69	46.00	53.00	56.79	
Share of RSA (%)	1.98	1.81	0.60	0.37	

SA=South Asia, RSA=Rest of South Asia
Source: COMTRADE accessed through WITS, and authors' calculations

In 2009, Nepal's overall trade balance with RSA was positive, recording trade surplus with Bangladesh, Sri Lanka and the Maldives, and deficit with the rest (Table 3). Notably, trade surplus with Bangladesh was nearly 84 percent of bilateral trade. Nepal has consistently had trade deficit with Pakistan, while no discernable trend is found for trade with others.

Table 3: Nepal's trade balance (US$ million)				
	1994	**1999**	**2003**	**2009**
World	-726.21	-823.19	-1,148.93	-2,868.39
India	-385.67	-433.26	-613.11	-1,569.12
Bangladesh	-14.23	9.23	1.25	55.44
Bhutan	-2.30	-0.43	0.80	-2.03
Sri Lanka	1.88	-1.39	-0.80	1.33
Pakistan	-4.48	-12.78	-2.31	-2.10
Maldives	-	-	-	0.05
Afghanistan	0.00	-	-0.03	-0.05
Note: Negative sign (-) signifies deficit. Source: COMTRADE accessed through WITS, and authors' calculations				

5.3 Trade potential

As noted above, an important reason for Nepal joining SAFTA was to expand its exports to the RSA and thereby contribute to geographic export diversification. Yet, as seen above, the size of exports to RSA, with the exception of Bangladesh, is trivial. This could be because the trade potential (potential for exports from Nepal to RSA) is low, and/or due to policy and structural factors (such as tariff, para-tariff and non-tariff barriers in the destination markets; high trade cost; transit difficulties; and supply-side constraints).

As can be seen from Table 4, total imports of most South Asian countries have grown faster than world imports during 2005-2009.

Table 4: South Asian market size and growth		
	Imports from world, 2009 (US$ billion)	**% annual average growth in imports (2005-2009)**
Afghanistan	3.34	-
Bangladesh	18.37	14
Bhutan	0.53	8
India	266.40	20
Maldives	0.98	10
Pakistan	31.58	8
Sri Lanka	9.43	6
World imports	12,650.12	6
Source: ITC Trade Map		

One way to assess the export prospects of a country in a regional trading arrangement is to look at the complementarity index. This index provides an idea of the compatibility of the export pattern of a country with the import of another, with a high degree of complementarity being assumed to indicate more favorable prospects for a successful trade arrangement (Mikic and Gilbert 2007).[26] Complementarity indices for 2009 show a high degree of complementarity between Nepal's exports and the imports of the Maldives, Bhutan and Afghanistan (Table 5). Complementarity with

[26] The index is calculated as the sum of the absolute value of the difference between the import category shares and the export shares of the countries under study, divided by two, and is converted to percentage form (Mikic and Gilbert 2007). The index takes a value between 0 and 100, with a higher percentage indicating a higher level of complementarity and vice versa.

Bhutan and the Maldives has increased over time, and was high a decade ago too. Complementarity index with respect to India takes a moderate value of 42.5 with no substantial change since 1999, while it is low (less than 33) with respect to other South Asian countries.

Table 5: Complementarity between Nepal's exports and its South Asian neighbours' imports

	1999	2003	2009
Afghanistan	-	-	60.97
Bangladesh	-	34.50	31.41*
Bhutan	75.40	-	80.73
India	41.77	38.59	42.50
Sri Lanka	36.56	27.11	32.49
Maldives	71.56	70.69	80.11*
Pakistan	-	29.33	28.78

* Figures for 2007
Source: WITS

However, it should be noted that when the size differences in the economies is large (i.e., a match in percentage terms does not imply a match in levels), the complementarity index, which is based on shares, may be misleading. Hence, we also use a measure of trade potential—i.e., Nepal's export potential—based on levels of exports (of Nepal) and imports (of the partner). For each tariff sub-heading at HS six-digit level, Nepal's export potential in a South Asian country is calculated by subtracting Nepal's actual exports to that country from the minimum of Nepal's total exports and the partner's total imports. Summing the export potential in all the tariff sub-headings yields the aggregate export potential of Nepal in the partner. This measure, though based on a static concept, gives an indication of the value of additional exports that Nepal can potentially make to another country, given Nepal's existing export capacity, the existing imports of the partner country and the existing exports from Nepal to that country. We use the trade potentials at HS six-digit level calculated by the ITC's Trade Map for 2009 and sum them to get the aggregate trade potential (Table 6).

Table 6: Trade potential of Nepal (exporter) in its South Asian neighbours (importer)

	Trade potential (TP) in 2009 (US$ million)	Exports in 2009 from Nepal to South Asian countries (US$ million)	Ratio of TP to actual exports from Nepal to South Asian countries
Afghanistan	11.83	0.03	394.17
Bangladesh	261.39	60.84	4.30
Bhutan	37.23	2.52	14.80
India	170.60	562.81	0.30

Maldives	65.43	0.05	1,258.35
Pakistan	314.84	1.11	283.38
Sri Lanka	269.04	2.09	128.91
Source: TP: aggregated on the basis of tariff subheading-wise trade potentials calculated by ITC Trade Map Exports value: COMTRADE/ITC Trade Map			

The figures in Table 6 show that there exists substantial potential for Nepal to increase exports to all of its South Asian neighbours; these markets remain significantly under-exploited by Nepal given its existing export capacity. Export potential value ranges from US$11.8 million to Afghanistan to US$314 million to Pakistan. Even with India, which already absorbs 63.5 percent of Nepal's exports, an export potential of US$170 million exists. In the RSA group, following Pakistan in terms of size of trade potential are Sri Lanka, Bangladesh, the Maldives, Bhutan and Afghanistan. Trade potential exceeds existing exports by factors ranging from 4.3 (Bangladesh) to 1,258 (the Maldives). With India, however, trade potential is 30 percent of current exports—which is not surprising given the already high concentration of exports in that market.

5.4 Market access conditions in RSA – tariff barriers

This section looks at the tariff barriers faced by Nepal in the top four markets in RSA (Bangladesh, Pakistan, Sri Lanka and Bhutan) and the coverage by the sensitive lists maintained by these countries of items of export interest to Nepal.

Table 7: Market access conditions in RSA: Tariff barriers faced by Nepal

Market	No of items on sensitive list (SL)	No. of items exported by Nepal	No. of exported items on SL and their percentage of export value	No. of exported items on SL entering duty-free	Applied tariff on exported items on SL	Applied tariff on exported items outside SL
Bangladesh	1,166	19	6 *(97.6)*	2 [year 2008]	0%, 7%, 10%, 12%, 25% (2 sub-heading) [year 2008]	0%, 5% (6 sub-headings) 12%, 23.75% (7 sub-headings) [year 2007]
Pakistan	1,169	17	5 *(48.5)*	0 [year 2010]	10% (1 sub-heading), 25% (4 sub-headings) [year 2010]	Required to have reduced it to 0-5 % by July 2009
Sri Lanka	1,065	6	2 *(14)*	0 [year 2009]	28% (1 sub-heading), 28% and a specific duty of Sri Lankan Rs 5/kg (1 sub-heading) [year 2009]	Required to have reduced it to 0-5 % by July 2009
Bhutan	150	51	1 *(0)*	0	50%	19%, 28.5% or 35% (45 sub-

				[year 2007]	[year 2007]	headings) 9.5% (2 sub-headings) 0% (2 sub-headings) [year 2007]
See text for further explanation Source: Tariff data from ITC Trade Map, TRAINS and COMTRADE (accessed through WITS); rest, authors' calculation						

Table 8: Coverage by RSA sensitive lists of items of Nepal's comparative advantage

Market	No of items in which Nepal has RCA>1 and partner's global imports > Nepal's global exports	No of items in col. 2 that are on SL	Indicative market value in partner for items in col. 3 (US$ million)	Indicative market value in partner for items in col. 2 but not on SL (US$ million)
Bangladesh	154	62	1,300	323
Pakistan	205	60	327.8	1,000
Sri Lanka	181	54	431	163.7
Bhutan	24	4	1	20.8

Indicative market value is calculated as the sum of the difference between partner's global imports and Nepal's global exports of the items in question
Source: Authors' calculation based on COMTRADE data accessed through WITS

Bangladesh

Nepal exported products in 19 sub-headings (HS 6-digit) to Bangladesh in 2009, with lentils accounting for 72 percent of total export value. Six of the sub-headings, representing over 97 percent of the value of Nepal's exports to Bangladesh, are on Bangladesh's sensitive list. In 2008, they attracted tariffs of 0 (in two sub-headings), 7, 10, 12 and/or 25 percent (in two sub-headings) (Table 7). Lentils, which is on the sensitive list, gets zero-tariff access but they are bound at 200 percent in the WTO schedule of concessions, leaving open the possibility of the tariff being increased to a prohibitive level. Three sub-headings are unbound. Tariff rates in six of the 13 sub-headings not on the sensitive list were already 0 or 5 percent in 2007. Tariffs in the remaining seven sub-headings were 12 or 23.75 percent in 2007; they must be reduced to 0-5 percent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual installments, not less than 10 percent annually. MFN tariffs on items outside the sensitive list are 0 percent (2 sub-headings), 7 percent (5), 12 (3) and 25 (3) in 2008.

It is pertinent to also look at whether products in which Nepal has comparative advantage are on the sensitive list of Bangladesh or not (Table 8). In 2009, Nepal had revealed comparative advantage (RCA) globally, as measured by RCA index[27], in 478 sub-headings at HS six-digit level. In 154 of these sub-headings, Bangladesh's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bangladesh for these products from Nepal provided Nepal can increase its

[27] A concept developed by Balassa (1965), RCA index is calculated as the ratio of the share of a country's total exports of a commodity in its total exports to the share of world exports of the same commodity in total world exports (Mikic and Gilbert 2007). RCA index greater than unity indicates that the country has a revealed comparative advantage in the commodity of interest.

export supply.[28] 62 (40 percent) of these 154 items are on Bangladesh's sensitive list (which has a total of 1,166 items for LDC-specific sensitive list), while the rest are outside it. These items represent a market in Bangladesh of US$1.3 billion, over and above what Nepal exports to the world.[29] Items outside the sensitive list also represent a substantial market of US$323 million.

This suggests that while Bangladesh's sensitive list appears to be a barrier, other factors, such as para-tariff barriers[30] and NTBs, transit-related problems, and Nepal's own supply-side constraints, should also be taken into account while addressing the issue of sub-optimal utilization of trade potential.

Pakistan

Nepal exported products in 17 sub-headings (HS 6-digit) to Pakistan in 2009, with HS 621420 (shawls, scarves, mufflers, mantillas, veils & the like (excl. knitted/crocheted), of wool/fine animal hair) accounting for 46 percent of total export value. Five of the sub-headings, including the top export item, representing 48.5 percent of the value of Nepal's exports to Pakistan, are on Pakistan's sensitive list. In 2010, they attracted tariffs of 10 (one sub-heading) or 25 percent (in four sub-headings). The SAFTA Agreement requires NLDC members to reduce tariffs to 0-5 percent on products imported from LDC members within three years of the date of entry into force of the Agreement, that is, by July 2009.[31] MFN tariffs on the 12 sub-headings not on the sensitive list were 0 percent (2 sub-headings), 5 percent (4), 10 percent (4), 15 percent (1) and 25 percent (1) in 2008 or 2010.

In 205 of the 478 sub-headings in which Nepal had RCA in 2009, Pakistan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Pakistan for these products from Nepal provided Nepal can increase its export supply. 60 (29 percent) of these items are on Pakistan's sensitive list (which

[28] A major limitation of the RCA index should be noted: it is affected by trade-distorting policies, whether in the exporting country or in other countries. Also, due to data constraints, we are computing RCA indices for just one year, although ideally RCA indices over, say, a three-year period would provide a more definite picture. The results should, therefore, be taken as indicative.

[29] Existing value of exports to Bangladesh is not considered here, unlike in the trade potential index. Same for other countries considered.

[30] This is particularly important because Bangladesh imposes several para-tariffs barriers, which appear legal because they represent ODCs within the meaning of GATT as noted above, in the form of infrastructure development surcharge (IDSC), supplementary duty (SD) and regulatory duty (RD), which add up to the protective effect of trade taxes (WTO 2006). Even the value added tax (VAT), which is supposed to be a trade-neutral tax, has been applied in a discriminatory manner, as a 15 percent VAT is imposed on imported items whereas the same product is exempted from VAT when it is produced domestically (World Bank 2006: 21). While tariff barriers in Bangladesh have secularly declined between 1991/92 and 2004/05, para-tariff barriers have actually increased by more than three times during the corresponding period, with the protection of agricultural products rising more rapidly in the recent period. For example, in 1991/92, the simple average weighted tariff was 17.64 percent and para-tariffs were 2.98 percent; these figures were 16.39 percent and 10.23 percent respectively in the year 2004/05 (World Bank 2006). Although the latest figures are not available, Bangladesh's schedule of concession submitted to the WTO shows that it charges 2.5 percent licence fees for all imports (see Bangladesh's schedule on WTO website). Similarly, five-tier SD rates of 20 percent, 60 percent, 100 percent, 250 percent and 350 percent are being applied by Bangladesh as of FY 2008-2009 and revenue from SD on imports was Tk. 23 billion in FY 2008-2009, which was one fourth of the total customs duty collected during the year (MoF/B 2010). This indicates that para-tariff barriers are still high in Bangladesh.

[31] Complete data are not available to verify if this has happened.

has a total of 1,169 items for LDCs). These items represent a market in Pakistan of US$327.8 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent an even greater market, of US$1 billion. Tariff on these items for Nepal must have been reduced to 0-5 percent by July 2009.

As in the case of Bangladesh, while Pakistan's sensitive list may be a barrier, other factors may also be at work. One of the serious issues, as noted by Adhikari (2010a), is the transit problems faced by Nepal while using Indian territory to access Pakistan.[32]

Sri Lanka

Nepal exported products in just six sub-headings (HS 6-digit) to Sri Lanka in 2009, with lentils accounting for 85.6 percent of total export value. Two of the sub-headings are on the sensitive list, representing 14 percent of the value of Nepal's exports to Sri Lanka. In 2009, they faced tariff peaks (28 percent), with one also facing a specific duty of Sri Lankan Rs 5 per kg.

It is not clear what is the actual tariff rate that lentil, the top export item (85.6 percent of exports), faces since Sri Lanka has five tariff lines within HS 071340, with the applied rate in 2009 ranging from 2 to 22.4 percent for LDCs, and the trade data being available at the six-digit level only. MFN tariffs on the three other sub-headings not on the sensitive list were 15 percent in 2009. As an NLDC, Sri Lanka was required to reduce tariff on items outside the sensitive list for LDC members to 0-5 percent by July 2009.[33]

In 181 of the 478 sub-headings in which Nepal had RCA in 2009, Sri Lanka's global imports exceeded Nepal's global exports, implying there is a potential additional market in Sri Lanka for these products from Nepal provided Nepal can increase its export supply. 54 (30 percent) of these items are on Sri Lanka's sensitive list (which has 1,065 items in total). These items represent a market in Sri Lanka worth US$431 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a market of US$164 million. Tariff on these items for Nepal must have been reduced to 0-5 percent by July 2009.

Here too, while the sensitive list appears to be a barrier, other factors should also be analysed.

Bhutan

Nepal exported products in 51 sub-headings (HS 6-digit) to Bhutan in 2009, the highest among RSA export partners. Export value is less concentrated in a few products than with respect to Bangladesh, Pakistan and Sri Lanka.

Only one (HS 940350: Wooden furniture) of the 51 exported items is on the sensitive list. It faces a prohibitive tariff of 50 percent and the export value is negligible. As for

[32] Exporting to Pakistan via Indian land route is extremely difficult because of transit-related problems. Attempts by the Nepali private sector to utilize the spare capacity of Pakistan International Airlines cargo at a discounted price so as to export to Pakistan to overcome these are yet to bear fruit.

[33] Complete data are not available to verify it this has happened.

the remaining 50 sub-headings, which are not on the sensitive list, in 2007, 45 faced tariffs of 19, 28.5 or 35 percent; two faced 9.5 percent and two entered duty free (tariff rate on one item is not known). They must be reduced to 0-5 percent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual installments, not less than 10 percent annually.

In 24 of the 478 sub-headings in which Nepal had RCA in 2009, Bhutan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bhutan for these products from Nepal provided Nepal can increase its export supply. Only four of these items are on Bhutan's sensitive list (which has a total of 150 items in its sensitive list). These items represent a market in Bhutan of US$1 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a much greater market worth US$20.8 million.

This suggests that Bhutan's sensitive list is in general is not a major barrier for Nepal to expand its exports to that country. Nepal would, however, want the reduction of tariffs on items not on the sensitive list to take place at a speedy rate. Moreover, Nepal's focus should be on other barriers and domestic supply capacity to tap the Bhutanese market.

It is pertinent to mention here that Nepal Trade Integration Strategy (NTIS) 2010 identified 12 products on the basis of their export potential and socio-economic impact (GoN 2010). NTIS also identified 10 most attractive markets for these products. India is in the top 10 list for five of the 12 products—the maximum for any country.[34] Among South Asian countries, following India is Pakistan, in four products, three of which are outside the sensitive list and one is in the sensitive list. Bangladesh is among the top 10 most attractive markets for one product and Sri Lanka for one product – in both cases, the product is in the sensitive list.

From the foregoing analysis, we observe that, overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA (for which a substantial market space exists). As for items outside the sensitive lists, which also represent a significant market, of interest is how fast the tariffs on them will be reduced to 0-5 percent. In addition, para-tariff and non-tariff barriers, transit-related problems and domestic supply-side constraints must be taken into account.

5.5 Nepal's tariff structure

As Nepal itself has the longest sensitive list in SAFTA (1,257 for LDCs and 1,295 for NLDCs), it should be prepared to prune its own while asking of the same from others. Nearly 48 percent of Nepal's global imports are covered by the sensitive list. In the case of imports from South Asia, sensitive list coverage is even higher (57 percent). Some 68 percent of total imports under sensitive list are from South Asia. Imports from South Asia under the sensitive list amounted to US$1.2 billion in 2009. The coverage by the sensitive list of imports from individual countries varies, however

[34] The five products from Nepal are eligible for basic customs duty-free access to India, subject, where applicable, to ROO.

(Table 9): it is in the range of 8-16 percent for Afghanistan, Bhutan, the Maldives and Sri Lanka, while it is 60 percent for India and 75 percent for Bangladesh. It must be noted that the huge coverage of imports by the sensitive list is driven by imports of petroleum products under Chapter 27 from India, amounting to US$558.3 million, which alone make up 46 percent of sensitive list imports from India and about 15 percent of total imports (inside and outside the sensitive list).[35]

Table 9: Import coverage by Nepal's sensitive list (2009)

Imports from	Imports of items under SL (US$1000)	Percentage of imports covered by SL	Total items imported (HS 6-digit)	Total imported items that are on SL
Afghanistan	7.47	9.30	10	5
Bangladesh	4,032.06	74.70	118	80
Bhutan	502.87	11.05	9	6
India	1,216,650.76	60.25	3,783	913
Pakistan	1,421.56	44.23	68	30
Sri Lanka	116.75	15.53	40	23
Maldives	0.08	8.37	2	1
South Asia	1,222,731.54	56.98		

Source: Authors' calculation based on COMTRADE data accessed through WITS

As noted in section 4, the presence of 140 agricultural products on Nepal's sensitive list is redundant in the light of the fact that basic customs duty-free access is provided to such products from India (and Tibet, China), which also happens to be a predominant supplier of the same. In 2009, Nepal actually imported 97 of the 140 products amounting to US$80.2 million, with India accounting for 85 percent and China 8 percent of the supplies. India and China accounted for 66 percent or more of imports in 86 of the 97 products. This illustrates the need to rationalize the sensitive list.

Application of objective criteria, backed by stakeholder consultation, should guide the process of pruning the sensitive list. Kharel (2010b) used four criteria for initial consideration of items to be removed from the sensitive list[36]: first, at least one South Asian country has RCA greater than unity in the product consistently for three years; second, South Asia supplies at least two thirds of Nepal's imports of the product consistently for three years; third, there exists trade potential (Nepal as an importer) for at least one South Asian country consistently for three years; and fourth, Nepal already provides duty-free access to the product if imported from India[37]. The criteria try to ensure that trade is created and trade diversion minimized as a result of sensitive list reduction. Since an important motive for keeping items on the sensitive list by Nepal is for revenue purpose (trade taxes on imports made up 21.7 percent of total tax revenue in 2009/10), the study also assessed the importance of the shortlisted items for revenue purpose. Combining the secondary data analysis with limited stakeholder consultation to assess the potential impact of tariff liberalization on the domestic

[35] These items are on the sensitive list mainly for revenue purpose.

[36] Trade data used in Kharel (2010b) were mirror statistics as no direct data were available at COMTRADE for the chosen period of 2005-2007.

[37] The last criterion was applied on a standalone basis.

sectors, the study identified 129 items for consideration for removal from the sensitive list, while recommending that measures, including provision of state support, be taken to enhance the domestic supply capacity in the sectors concerned.

Apart from providing basic customs duty-free access to listed agricultural products from India, Nepal also provides preferential tariff treatment, albeit marginal, to other goods from India, as per the bilateral trade treaty. In 2010/11, the tariff concession consisted of a 7 percent rebate on *ad valorem* customs duty for goods attracting *ad valorem* tariff of up to 30 percent and a 5 percent rebate for goods attracting *ad valorem* tariff of more than 30 percent. Besides this general rebate, tariff concessions are provided also to some specific products imported from India.[38] Nepal should consider extending the same preferential treatment to all SAFTA members, subject to ROO as agreed under SAFTA, including for India.

Table 10 provides a summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members for the year 2010 based on the WTO's Tariff Analysis Online database. Considering only *ad valorem* duties due to data constraints, in 2010, Nepal's simple average preferential duty for SAFTA members (LDCs and non-LDCs) is 10.79 percent, or 1.39 percentage points lower than its simple average MFN applied duty.[39] This absolute difference is slightly higher than when the average is taken over non-duty-free tariff lines only. A total of 135 tariff lines are duty free on an MFN basis (by definition, also applicable to SAFTA members). Available data indicate that there are no duty-free tariff lines exclusively for SAFTA members under SAFTA. Tariff dispersion is lower for SAFTA preferential rates than for MFN applied rates. The minimum and maximum duties are the same for both duty types.

[38] A 50 percent tariff rebate is accorded on cotton vest, cotton underwear, cotton brassier and cotton panty (as per Finance Act 2010/11).

[39] The tariff lines are at the national level (i.e., beyond HS 6-digit level where applicable).

Table 10: Summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members, 2010										
Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty2	Absolute difference (Duty2 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty2	Min Duty1	Max Duty 1	Min Duty2	Max Duty2
All TL excl. NA	5,127	12.18	10.79	-1.39	8.6	7.36	5	80	5	80
Duty1, Duty2 *Ad valorem* dutiable	4,992	12.51	11.08	-1.43	8.48	7.24	5	80	5	80
Duty1 = Duty2	2,819	11.92	11.92	0	9.09	9.09	5	80	5	80
Duty1 > Duty2	2,173	13.29	10	-3.29	7.54	3.35	10	80	5	24
Duty1, Duty2 are duty free	135	0	0	0						
Duty1 is NA	41									
Duty2 is NA	41									
Preferential duty only for LDCs										
Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty3	Absolute difference (Duty3 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty3	Min Duty1	Max Duty 1	Min Duty3	Max Duty3
Duty 1> Duty 3	37	18.51	11.14	-7.37	5.31	1.65	10	30	8	12

TL = Tariff line (national, beyond HS 6-digit level where applicable)
Duty1 = MFN applied duty rates
Duty2 = Preferential duty rates for all SAFTA members (LDCs and non-LDCs)
Duty3 = Preferential duty rates for LDCs only
NA = Not available

Source: WTO's Tariff Analysis Online

The SAFTA rate is lower than the MFN rate in about 44 percent of *ad valorem* dutiable tariff lines; the absolute difference of the simple average rates in these 2,173 tariff lines is 3.29 percentage points, which is higher than when the comparison covers all tariff lines. Tariff dispersion is also much lower for SAFTA rates that are

lower than MFN rates. Also, the maximum SAFTA rate on the 2,173 tariff lines where the MFN duty is higher than the SAFTA duty is 24 percent, as opposed to 80 percent for MFN duty. A total of 117 out of these tariff lines for SAFTA members have tariff peaks, defined as duties equal to or greater than 15 percent. Since MFN rate is higher than SAFTA rate in these tariff lines, by implication these are outside Nepal's sensitive lists for both LDCs and non-LDCs. Nepal has until 2016 to phase in its tariff liberalization programme under SAFTA. The SAFTA duties on these tariff lines will have to fall into the range of 0-5 percent by 2016.

There are 37 tariff lines in which preferential duty is granted to LDCs only. In these tariff lines, the margin of preference for LDCs in terms of simple average duty is 7.37 percentage points. The minimum and maximum rates for LDCs in these tariff lines are 8 percent and 12 percent, respectively, as opposed to the MFN rates of 10 percent and 30 percent. The SAFTA duties for LDCs on these tariff lines will have to fall into the range of 0-5 percent by 2016.

In 2,819 tariff lines the MFN rates are equal to the SAFTA rates. Table 10 shows that the simple average duty on these tariff lines is 11.92 percent, with a standard deviation of 9.09. Of these, 1,327 tariff lines attract 5 percent duty, while 1,131 tariff lines face tariff peaks.

Now, analysing ad valorem duties on HS 2007 6-digit tariff sub-headings (not national tariff lines) available at the WTO's Tariff Analysis Online database for the year 2010, we find that some 1,078 tariff sub-headings on the sensitive list for non-LDCs are subject to tariff peaks, thus indicating considerable scope for further tariff liberalization by Nepal under SAFTA.

5.6 Non-tariff and para-tariff barriers

Perhaps because exports to RSA are limited, the issue of NTBs and para-tariff barriers in these countries has not come to public attention in Nepal prominently. However, going by the experiences of other countries in the region, such barriers are a serious restriction on trade.[40] The majority of NTBs relate to SPS, technical barriers to trade (TBT) and other related measures (ADB and UNCTAD 2008).

The current institutional mechanism under SAFTA to deal with NTBs and para-tariff barriers is fairly weak. Under the existing rules, the member states notify the SAARC Secretariat the non-tariff and para-tariff measures they face on their exports on an annual basis. The notified measures are reviewed by the Committee of Experts (CoE), established under Article 10, in its regular meetings to examine their compatibility with relevant WTO provisions. The CoE recommends the elimination or implementation of the measure in the least trade restrictive manner in order to facilitate intra-SAARC trade. A majority of notifications and complaints are being dealt through bilateral negotiations (Rahman 2010b). The CoE acts as the dispute

[40] SAFTA member states notified non-tariff and para-tariff measures they faced in other member states and responded to notifications related to them at the 4th SAFTA Sub-Group Meeting of the Committee of Experts (CoE) held in Kathmandu in October 2009. See Rahman (2010b).

settlement body under SAFTA, but its role in settling disputes related to NTBs and para-tariff barriers has not been satisfactory.

5.7 Transit problems

The quality of transit facility that a landlocked country enjoys is an important determinant of its trade with countries other than its bordering neighbours. Nepal completely depends on transit passage through India as well as Indian sea ports for its surface and sea-borne trade with the rest of the world.[41] Even if Nepal were to use the sea ports in Bangladesh, transit passage through India would still be unavoidable for trade with and through Bangladesh.

Political relationship with India has had an important bearing on the transit facility, an extreme case being the blockade imposed by India on Nepal in 1989-1990. Even in normal times, it faces numerous transit-related problems, resolving which is critical for increased trade integration with RSA as well as the rest of the world. A host of transit restrictions is in place, causing delays, raising the landed prices of imports and eroding export competitiveness. The restrictions operate at two levels: transit to access Indian sea-ports, and transit through Indian territory to access Bangladeshi markets and sea-ports.[42]

Cumbersome transit processes, including procedural controls, citing the possibility of trade deflection, are in place. It is customary for Indian authorities to issue unilateral notifications on transit and customs matters, adding to the unpredictability stemming from the bilateral Transit Treaty's lack of unconditional automaticity in renewal. Hassles in the form of multiple checking agencies mar the entire transit process. Actual documentary requirements are higher than those specified in the treaty.

Although the transit treaty requires duty insurance (to hedge the risk of trade deflection and the resulting loss of customs duties for India) only for goods deemed sensitive by the Indian government, the list of such goods is not made public to Nepali traders. The monopoly of the Kolkata-based office of the Indian National Insurance Company Limited on issuing duty insurance policy means a high premium rate (Kaphley 2007). While insurance policy needs to cover only Indian customs duty if the goods are transported by rail, goods transported in private-owned vehicles by road have to be insured to the difference between the market value and the cost-insurance-freight (CIF) value (Kaphley 2007). The premium amount is also jacked up due to the fixation of the market value by Indian customs at an unreasonably high level, at 200 to 250 percent of CIF value (ibid).

Transit through India is subject not only to central government regulations and formalities but also those that are in force in the states. Further, although the Indian road freight market is generally competitive, Nepal has not been able to benefit from it fully due to the enforcement of minimum freight tariffs for the transportation of Nepali cargo in three Indian states bordering Nepal, namely, Uttar Pradesh, Bihar and

[41] Transit trade through China, which borders Nepal to the north, is restricted by the Himalayas, inadequate transport links as well as the distance to the nearest sea port in China.

[42] Transit through India is also a problem for Nepal's overland trade with Bhutan and Pakistan. Here, we focus on transit through India to Bangladesh.

West Bengal (CIC 2001). Nepali cargoes are subject to state-level taxes as well as bribes (Nepal 2006).

Administrative rigmarole, gross inefficiency and congestion—resulting in delays, higher turnaround time, detention and demurrage—define Kolkata and Haldia ports, the gateway ports for Nepal's third-country trade. In addition, Nepali importers have to pay penalty charges not only for the delayed portion of the cargo but also on the entire cargo, particularly in the case of bulk cargo, when such cargo is transported in partial shipments. Demurrage is charged even if goods are not cleared due to conditions beyond the control of the importer such as labour strikes (Nepal 2006).

The operationalization of an inland container depot (dry port) at Nepal's main border point (Birgunj), which is connected by a rail link to Kolkata port through a bilateral rail services agreement signed in May 2004, was expected to reduce transit costs from 12−15 percent of CIF to 8−10 percent and the journey time between Kolkata and Birgunj from 10 days to 3 days (CIC 2001). However, the full benefits are yet to be realized as, among other problems, through bills of lading (TBLs) are still not provided (Rajkarnikar 2010). The most important advantage of issuing and receiving TBLs at a dry port is that they reduce customs and clearance activities at sea-ports to a minimum, with only the transport activities of transit being emphasized (CIC 2001). If all documents are in order, cargoes have to spend three to five days at the port, which could be reduced if TBLs are issued and received at the dry port (ibid). Other problems include: non-availability of round-the-clock customs, only the movement of a few types of wagons being allowed, idling of costly reach stackers, non-integration of customs procedures, and deficiency in the infrastructure design of the dry port. Rough estimates suggest that the dry port is underutilized, operating at only 25 percent of its normal capacity (NITDB 2008).

Nepal has long sought alternative ports in India as Kolkata and Haldiya are not only congested and inefficient but also cannot accept mother vessels, necessitating costly transshipment in other ports. Using Jawaharlal Nehru Port (JNP) in Mumbai, for instance, is estimated to reduce transit cost by US$400 per 20-foot container by, *inter alia*, avoiding transshipment, thereby improving the competitiveness of Nepal's West-bound exports (CIC 2001). India agreed in principle in 1995 to allow Nepal to use JNP and Kandla port on the western coast of India for its third-country trade. The pledge was not implemented. Later, another study[43] recommended using Visakhapatnam Port located on the eastern coast of India in the state of Andhra Pradesh as an alternative to Kolkata port as the port has spare capacity and draft conditions permitting berthing of mother vessels of up to 100,000 deadweight tonnage and is also much more efficient than Kolkata port in handling containers. In August 2009, India agreed to allow Nepal to use Visakhapatnam Port. However, India has put forth the condition of a double-seal[44] system on Nepali cargoes for Nepal to use Visakhapatnam Port, which is not the standard international practice and could complicate transit.[45]

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[43] See NITB (2008).

[44] Freight forwarders seal the cargo in transit in order to ally the fear of leakage. Not satisfied with this, Indian authorities want to put a second seal to be double sure. This adds to the cost of trading not least because it adds one more layer of bureaucratic hassle for traders.

[45] See Shrestha (2011).

Chittagong and Mongla ports in Bangladesh are potential alternative ports for Nepal. While Chittagong is said to be among the least-productive container ports in the world (Simon 2009), Mongla offers a viable option for carrying out at least part of Nepal's third-country trade more efficiently. Although a transit agreement between Bangladesh and Nepal signed in 1976 and a protocol to it give Nepal transit facility to access overseas markets through Bangladeshi territory and sea-ports, lack of cooperation with India in providing railway transit facility to Nepal for third-country trade via Bangladesh has prevented Nepal from utilizing that option. Mongla port is an under-utilized port (with 80 percent spare capacity) with a much lower cost of holding of goods compared to Kolkata port due to shorter turnaround time, and lower detention and demurrage. Moreover, the Government of Bangladesh had announced a 50 percent discount on port charges for Nepali trade handled through Mongla port and the notification could be extended if and when Nepal is able to trade through that port (NTDB 2008). Further, Bangladesh has a huge trade deficit with India with the result that cargo trains carrying exports from India to Bangladesh through a major route[46] return with empty wagons (ibid). Utilization of these empty wagons for Nepal's imports from Bangladesh and third countries can potentially take place at competitive railway tariffs (ibid).

An important benefit of having an alternative sea-port is that it creates/increases competition, frequently resulting in a substantial drop in charges for container slots. It should be noted, however, that apart from the lack of transit facility through India, the non-linking of Mongla port with railway services also discourages third-country containerized movement through the port, given that a major portion of Nepal's imports is in containerized form (ibid).

In a positive development, the Joint Communiqué issued by the governments of Bangladesh and India at the end of the visit to India by Bangladesh's prime minister on 10-13 January 2010 included an agreement to grant railway transit facility to Nepal through the Rohanpur-Singhabad point for its trade with and through Bangladesh. Simple transit procedures and issuance of TBLs are necessary to maximize the gains from this agreement for Nepal.

A 1997 agreement between Nepal and India already allows Nepal road transit via a single route for trade with and through Bangladesh (the 54-km Kakarbhitta (Nepal)-Phulbari (India)-Banglabandh (Bangladesh) route). It is estimated that routing trade through this route from Kathmandu to Mongla port will result in time savings of up to 94 hours and cost savings of about US$35 per ton compared to the existing corridor involving Kolkata port (Rahmatullah 2010). But a host of transit problems stymies cargo movement through this route (see Kharel 2009 and Nepal 2006). Cargo movement is allowed only at specified times in daylight hours in weekdays. Trucks carrying cargo-in-transit must move in convoys of a maximum of 20-25 trucks. Security escort is mandatory and provided only when there is a convoy of 25 trucks. There is no permanent customs office at the Fulbari border post in India. Poor implementation of a one-time lock system is combined with the poor state of infrastructure on the Indian side of the border. Indian insurance companies enjoy

[46] Via the Singhabad-Rohanpur interchange point, the nearest operative point to two major economic hubs of Nepal through which some 87 percent of Nepal's foreign trade passes.

monopoly power, goods have to be trans-shipped at the Bangladesh-India border, and there is no provision of TBLs by shipping lines. The involvement of third-party (Indian) customs is an additional burden. Besides the problems vis-à-vis India, Bangladesh's policy of not allowing foreign trucks to operate in its territory causes delays at the border, as cargoes have to be transshipped from Nepali trucks into Bangladeshi trucks.

Although, as argued by Faye et al. (2004:45), "there is a legal basis for rights of landlocked transit as outlined in Article 125 (1) of the United Nations Convention on the Law of the Sea" (United Nations 1982), this does not mean much as, "in practice, this right of access must be agreed upon with the transit neighbour (Article125 (2) and (3)) and is determined by the relationship between the countries." Moreover, Article V of the GATT also provides similar rights, but this has not been invoked so far probably due to conflicting interpretations of the provision (Adhikari 2010a). Discussions on this issue are taking place at the ongoing Doha Round of trade negotiations under the broad rubric of trade facilitation. However, whether or not there will be any meaningful outcome on this will depend significantly on the final outcome of the Doha Development Agenda, which itself is in limbo (see Adhikari 2009).

In order to remedy this persistent problem of transit, Kharel (2009) makes a case for a regional transit arrangement in South Asia that simplifies and harmonizes rules, regulations and procedures for goods and vehicles in transit across countries—backed by investments in infrastructures (including roads, railways and sea-ports), and communications systems, and the establishment and improvement of regional transport corridors. Such an arrangement will benefit not just Nepal and the two other landlocked countries of the region (Afghanistan and Bhutan) but also the non-landlocked ones (ibid). It will also help create a level playing field for relatively weaker countries in the region. As lowering trade costs this way facilitate trade with the rest of the world as well as with neighbours, they do not give rise to welfare-enhancing trade diversion that can arise from preferential tariff reduction (Hoekman and Wilson 2010).

6. Supply-side constraints

Nepal faces severe supply-side constraints, overcoming which is critical for exploiting existing market access opportunities and improving its export performance. An important supply-side constraint (poor transit facility) was discussed in section 5.7. This section discusses other supply-side problems.

Broadly following the growth diagnostics developed by Hausmann et al (2005), ADB et al (2009) identified a number of critical constraints to Nepal's growth which are causing low social returns to investment and/or low private appropriability of returns to investment: a) limited and low quality infrastructure (namely, electricity and transport network and irrigation); b) weak governance (political instability and corruption), poor industrial relations climate and labour market rigidities; and c) market failures (information and learning externalities and coordination failures) indicated by domestic manufacturing being low in technology quality and not growing, and exports being low in volume and in technology quality. These factors adversely affect Nepal's export competitiveness also.

The major binding competitiveness-related supply-side constraints are inadequate infrastructure for efficient production and transportation of goods; lack of human capital endowed with education and skills to process exportables; limited access to credit due to conventional/conservative banking practices that rely more on collateral than on the feasibility of business ventures; limited use of technology in the production processes which impedes the prospects of what is known as "moving up the value-chain ladder"; and virtual absence of trade facilitation measures which causes delays in the shipment of goods.[47]

These features are also reflected in Nepal's ranking in the Global Competitiveness Report (GCR) published by the World Economic Forum, which bases its analysis on 12 different indicators of competitiveness. While all the factors analyzed by the GCR are necessary to measure the level of competitiveness of the economy, we focus on four factors that have been identified as the major binding constraints by earlier studies, namely: infrastructure, human capital (represented by health and primary education), access to finance (represented by ease of access to loan), and access and adaptability to technology (represented by technological readiness), based on the ranking and index prepared by the GCR 2010-2011 (Table 11). The table shows that in terms of various competitiveness rankings, Nepal falls below other South Asian countries (including Bangladesh, an LDC), in terms of infrastructure, ease of access to loan, and technological readiness, although it has a better indicator than Pakistan in the case of health and primary education.

Table 11: Select competitiveness rankings and indices, 2010-2011

	Infrastructure		**Health and primary education**		**Ease of access to loan**		**Technological readiness**	
Country/Economy	Rank	Index	Rank	Index	Rank	Index	Rank	Index
	N = 139	(1 to 7)	N = 139	(1 to 7)	N = 139	(1 to 7)	N = 139	(1 to 7)
Switzerland (Overall, top)	6	6.1	7	6.6	22	3.7	7	5.6
Bangladesh	133	2.1	106	5	79	2.6	126	2.7
India	86	3.5	104	5.2	39	3.3	86	3.3
Nepal	139	1.8	109	4.8	88	2.5	134	2.5
Pakistan	110	2.8	123	4.3	40	3.3	109	2.9
Sri Lanka	70	3.8	35	6.2	38	3.3	84	3.4
Chad (Overall, bottom)	137	1.8	138	2.9	115	2.1	138	2.3

Source: World Economic Forum's Global Competitiveness Report 2010-2011.

Nepal continues to produce and export "poor country goods"[48] and its efforts at enhancing its competitiveness and achieve export diversification have neither produced satisfactory results, nor are targeted at moving up the value chain ladder. In terms of research and development (R&D), as measured by industrial value addition,

[47] See, for example, Raihan et al (2007); Adhikari and Weeratunge (2007).

[48] According to Hausmann et al (2005), "poor country goods", as the name suggests, are low-value goods produced by poor countries, with low technology and skill components.

business sophistication index, innovation index and technological readiness index, Nepal ranks much lower than its South Asian neighbours, including Bangladesh (Table 12).

Table 12: Productive capacity, sophistication, innovation and technological readiness in South Asia, 2010-2011, N = 139

Country	Industrial value addition	Business sophistication index		Innovation index		Technological readiness index	
	(% of GDP) 2007	Rank	Score	Rank	Score	Rank	Score
Bangladesh	29	105	3.4	119	2.6	126	2.7
India	29	44	4.3	39	3.6	86	3.3
Nepal	17	132	3	137	2.3	134	2.5
Pakistan	27	79	3.7	75	3	109	2.9
Sri Lanka	30	39	4.4	40	3.6	84	3.4

Source: World Economic Forum's Global Competitiveness Report 2010-2011

Like many other indicators of trade competitiveness, Nepal's trade facilitation indicators, which could make or break the trading prospect of any country, are poor. The trading-across-borders indicators published by the World Bank's Doing Business Report, which is one way of measuring trade facilitation indicators, show that Nepal ranks 164th among 183 countries and is ahead of only Afghanistan in South Asia in overall ranking (Table 13).[49] Nepal's performance is worse than the South Asian average (and obviously the OECD average by a huge larger margin) in all the indicators.

Table 13: Trading across borders indicators for South Asian countries, 2011

Indicators	South Asian LDCs					South Asian developing countries			South Asia (average)	OECD (average)
	AF	BD	BT	MV	NP	IN	PK	SL		
Doing business - trading across borders (rank out of 183)	183	112	161	138	164	100	81	72		
No. of documents required for exports	12	6	8	8	9	8	9	8	8.5	4.4
No. of days required for exports	74	25	38	21	41	17	21	21	32.3	10.9
Cost to export (US$ per container)	3,865	985	1,210	1,550	1,960	1,055	611	715	1,511.60	1,058.70

[49] It should be noted that for a landlocked country, the documents, time and cost to import and export are a function not only of domestic factors but also the situation in the transit country and the transit facility.

No. of documents required for imports	11	8	11	9	10	9	8	6	9	4.9
No. of days required for imports	77	31	38	22	35	20	18	19	32.5	11.4
Cost to import (US$ per container)	3,830	1,390	2,665	1,526	2,095	1,025	680	745	1,744.50	1,106.30

Note: AF = Afghanistan; BD = Bangladesh; BT = Bhutan; MV = Maldives; NP = Nepal; IN = India; PK = Pakistan; SL = Sri Lanka
Source: World Bank's Doing Business Report 2011

Similarly, the Logistics Performance Index (LPI)—a composite index of various logistics and trade facilitation indicators —ranks Nepal one of the lowest, i.e., 147 out of the 155 countries surveyed in 2010 (Table 14). Nepal's ranking, compared to 2009, has not only slipped by 17 positions, but also been surpassed even by Afghanistan.

Table 14: LPI of South Asian countries (1 to 5 best), 2010

Indicators	South Asian LDCS					South Asian DCs		
	AF	BD	BT	MV	NP	IN	PK	SL
Overall LPI	143	79	128	125	147	47	110	137
Customs	104	90	118	98	130	52	135	143
Infrastructure	139	72	141	111	143	47	120	138
International shipments	141	61	120	125	143	46	66	117
Logistics competence	141	96	127	117	143	40	120	142
Tracking and tracing	128	92	105	121	140	52	93	142
Timeliness	146	70	122	133	139	56	110	125

Note: As in Table 13
Source: World Bank's Logistics Performance Indicators 2010

Thus, based on the extant literature and globally accepted indicators of supply-side constraints, Nepal faces severe supply-side constraints on all major fronts, which means that it would not be in a position to fully utilize whatever limited market acess opporunity is granted under SAFTA. The preference erosion that Nepal is facing in the India market, as discussed above, is likely to futher excacerbate the problem.

In order to help Nepali enterprises enhance their competitiveness in international markets, the Government of Nepal has not been able to offer export incentives worth their name. Although the budget speech for FY 2010/11 offered a cash incentive of 2-4 percent for exporters depending on the level of value addition, the incentive has not been operationalized so far. Further, as the government explicitly mentioned that such a facility would be provided to only convertible currency-denominated exports, the incentive exludes the bulk of the exports as exports to India are denominated in the Indian currency. Although this was apparently done with a view to diversifying Nepal's exports to other destinations than India (both within and outside the region), only a third of exports being eligible for such facility means that most exporters would be deprived of enjoying the benefit, if and when the scheme comes into operation.

7. Conclusion

Notwithstanding the coming into force of SAFTA, Nepal's trade with South Asia remains concentrated with India. The restrictive provisions in the bilateral trade treaty with India, along with other barriers, have, however, contributed to Nepal's deteriorating trade balance with its largest trading partner. While Bangladesh has emerged as Nepal's third largest export market globally, the growth in exports to it is overwhelmingly due to the surge in exports of a single agricultural commodity (lentils). Trade with RSA is neglible in relation to Nepal's total trade.

A substantial export potential exisits with RSA, but a combination of market access barriers and supply-side constraints hinders the realization of this potential. Overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA and for which a substantial market space exists. As for items outside the sensitive lists, which also represent a significant market, of interest is how fast the tariffs on them will be reduced to 0-5 percent. Meaningful pruning of sensitive lists by RSA countries will help Nepal gain from SAFTA.

As Nepal itself has the longest sensitive list in SAFTA, it should be prepared to prune its own while asking of the same from others. Application of objective criteria, backed by stakeholder consultation, should inform the process of pruning the sensitive list. The presence of some 140 agricultural products on Nepal's sensitive list is redundant in the light of the fact that basic customs duty-free access is provided to such products from India (and China), which also happens to be a predominant supplier of the same. This illustrates the need to rationalize the sensitive list. Nepal should remove these items from the SAFTA sensitive list or negotiate a revision to the trade treaty with India to be able to provide tariff protection to those agricultural products identified as being sensitive on rural livelihood and food security grounds by a comprehensive study and adjust the SAFTA sensitive list accordingly.

In general, Nepal should strive to accord the same treatment on trade matters to all SAARC members. This is important to reduce the cost of trade diversion and alleviate the stress on scarce capital for negotiating and implementing multiple trade agreements. However, in the event of absolute necessity to protect the domestic industries from unfair trade competition, Nepal can make use of trade remedy measures. It would be possible only if Nepal could enact necessary legislation, designing institutional mechanisms and building the capacity of public officials to impose such measures. This is an issue some stakeholders have been advocating for a while (see, for example, Adhikari 2004).

The ROO under SAFTA needs to be made simple, transparent and, for LDCs, less stringent. A single criterion of 20 percent value addition—backed up with a credible deadline for increasing the same (say, in 10 years) to ensure enhanced domestic supply capacity—would be helpful for Nepal to expand exports to South Asian countries (Adhikari 2010a).

As tariff barriers come down, the importance of NTBs and para-tariff barriers increase. Implementation of the provision of the SAFTA Agreement for the removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive is essential to effectively gain from tariff reduction. A regional mutual recognition agreement on SPS measures and technical standards and eventually a harmonization of such measures and standards under SAFTA could be an effective way to deal with NTBs. As a least-developed country with low capacity to upgrade its standards, however, Nepal needs financial, technical and capacity-building assistance to benefit from such an agreement. Because Nepal is close to eliminating all para-tariff barriers, it can take the lead in pushing for the elimination of such barriers in intra-regional trade. Nepal's major interest in SAFTA effectively dealing with NTBs and para-tariff barriers is that such barriers that Nepal itself faces in its largest export partner, India, could be addressed in the process. Implementation of trade facilitation

measures, as provisioned in Article 8 of SAFTA, will also hold significance for Nepal-India trade.

Transit-related problems, which add to trade costs, constrain Nepal's trade with RSA, particularly Bangladesh, Bhutan and Pakistan (and also the rest of the world). A regional transit arrangement, backed by investments in transit transport infrastructure, leading to an effective, efficient, integrated and harmonized transit transport system, will be appropriate to address many of the transit-related problems faced by Nepal. It should be compatible with the multilateral regime. Through a regional agreement, Nepal stands to secure better transit rights, and the realization of such rights will be less dependent on its political relationship with any particular country as any restriction and the resultant dispute will be a regional issue as opposed to a bilateral issue. It will be a key to unlocking Nepal's trade potential with RSA. As it will benefit not just Nepal and the two other landlocked countries of the region (Afghanistan and Bhutan) but also the non-landlocked ones, there is a compelling case for such an arrangement. Such a regional transit arrangement may be as an effective approach to implementing the provision for adoption of trade facilitation measures as per Article 8 of the SAFTA Agreement.

For an effective implementation of SAFTA, there is an acute need for an independent dispute settlement body (DSB), including an independent Appellate Body where parties to a dispute can appeal panel reports. The implementation mechanism to ensure compliance with DSB decisions must be strengthened. Special treatment must be accorded to LDCs in all stages of the determination of the causes of disputes and dispute settlement procedures. The special treatment should cover, *inter alia*, exercise of due restraint by developing country members in initiating complaints against LDC members, in seeking compensation from LDC members and taking retaliatory measures against LDC members. The creation of an effective dispute settlement mechanism under SAFTA also opens the avenue for settling bilateral trade disputes with India at an independent body at the regional level.

Nepal faces severe supply-side constraints, overcoming which is critical for exploiting market access opportunities and improving its export performance, not only within the region but also outside. Addressing some of the binding constraints—e.g., infrastructure—requires resources on a scale that cannot be met through domestic mobilization alone.[50] In this regard, the setting up and mobilization of an LDC Integration Fund, as proposed by Adhikari (2010b), with a focus on infrastructure creation could be a solution. Though it is difficult to quantify the size of the fund without adequate need assessments, an indicative portfolio with an annual contribution of US$1.1 billion, calculated at 0.07 percent of the GDP of SAARC member states, can be created (ibid.). The figure of 0.07 percent is 10 percent of what the United Nations has urged the members of the OECD Development Assistance Committee to contribute in the form of Official Development Assistance. Financing should be provided through various sources, including *core contribution* from members, donors and SAARC observers, *bilateral contributions* from developing countries in the region as per the spirit of the Article 11 (d) of SAFTA and *project-based contribution,* which can come from the Aid for Trade resources (ibid.).[51]

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[50] See ADB et al (2009).

[51] The Aid for Trade initiative was launched at the WTO Ministerial in Hong Kong in 2005. AFT, among others, intends to directly address the issue of supply-side constraints. As stated in paragraph 57 of the Hong Kong Ministerial Declaration, "....Aid for Trade should aim to help developing countries, particularly LDCs, to build the *supply-side capacity* and *trade-related infrastructure* that they need to assist them to implement and benefit from WTO Agreements and more broadly to expand their trade..." (WTO 2005) (emphasis added).

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